Statement for

Advisory Committee on the Auditing Profession
Department of the Treasury

by

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Thank you for inviting me to submit this statement in connection with hearings of the Advisory Committee on the Auditing Profession, Department of the Treasury, to be held December 3, 2007. This statement addresses matters set forth in the Committee's Working Discussion Outline, principally Item 3 and some discussion under Item 4. It has three Sections: Section I, Liability, discusses primary issues of liability system design; Section II, Governance, considers secondary issues bearing on that design; and Section III, Proposals, notes how financial statement insurance and auditor liability bonds can meet challenges being identified.

I. LIABILITY

This Section addresses issues in the law governing auditor duties and breaches, attending to the Committee's interest in changes to the auditor liability system. It outlines principles that underlie a liability system, notes limitations on auditor liability risk adopted in the 1990s, their effect in reducing litigation, and their relationship to the financial frauds and fallout of the late 1990s and early 2000s. Analysis of deterrence, auditor independence, legal flexibility and insurance supports maintaining, or possibly increasing, the existing liability system's strength (analysis in Sections II and III tends to reinforce this tentative conclusion).

A. *Deterrence*. Economic and legal principles concerning remedies designed to deter undesirable behavior are straightforward. Experience in the auditing environment of the past fifteen years indicates that the principles are sound.

1. Economics of Remedies. A basic principle of economics instructs that if the costs of some conduct increases, the amount of that conduct should fall (and vice versa). Traditional legal doctrines follow this principle to assume that actors are influenced by the expected costs and benefits of their behavior. In many areas of law, this leads to evaluating liability regimes in terms of their deterrent effect. This is especially so for tort law, which sets status-based duties and penalizes conduct such as negligence and fraud. It is also true for criminal law. To deter undesirable conduct, expected costs must exceed expected benefits. That means willingness and flexibility to award remedies for violations above those required to compensate injured parties.

Regimes that limit remedies to compensation or restitution (*e.g*., repaying benefits received, such as fees) do not deter. The prime example of this kind of regime is found in contract law, which governs voluntary exchange based on promise and performance. Economic theory holds that it is socially desirable for some contracts to be breached. This occurs when, by breaching, a party can generate enough gains to compensate the aggrieved party plus both make a profit and transfer the contract's subject matter to one who values it more highly. As a result, contract law awards compensation or restitution for breach, but not punitive damages.

Auditor duties fit within tort's approach to damages, not contract's approach. Society is better off when auditors perform their duties effectively rather than when they breach them. Damages for auditor liability thus should be designed to include deterrence. That explains why law has made tort-like damages available for auditor breaches rather than limiting them to contract law's compensation and restitution framework. Otherwise, auditors would be encouraged to breach duties because the cost is limited to relinquishing enough gains to compensate aggrieved parties.[1]

2. Observed Phenomena. Experience of the past fifteen years supports the soundness of the foregoing principles and doctrines. A series of legal changes during the 1990s reduced the deterrence level supplied by the liability regime governing auditors. These included imposing statutory caps on auditor damages that limited liability in proportion to culpability (reversing the traditional rule of joint and several liability);[2] eliminating the possibility of recovering treble damages from auditors under the RICO statute in securities fraud cases;[3] shortening the statute of limitations in federal securities fraud cases;[4] prohibiting private lawsuits against auditors for aiding and abetting issuer fraud;[5] establishing demanding pleading standards to allege securities fraud;[6] and outlawing state court class actions alleging securities fraud.[7]

Following these reductions in auditor liability risk during the 1990s, lawsuits against auditors fell. An SEC study showed that the number of lawsuits filed against the largest accounting firms during 1990 to 1992 (when there were six such firms) was 192,

[1] Public law enforcement can complement private law enforcement but is not a substitute. Governmental enforcement priorities shift over time. The SEC shifted its priorities away from auditing firms and towards other matters during most of the 1990s. *See* JOHN C. COFFEE, JR., GATEKEEPERS 61-62 (2006).

[2] Private Securities Litigation Reform Act of 1995 (PSLRA) § 201 (codified at 15 U.S.C. § 78u-3).

[3] PSLRA, § 107 (1995).

[4] *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilberston*, 501 U.S. 350 (1991).

[5] *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

[6] PSLRA, § 101 (1995); *see Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007).

[7] Securities Litigation Uniform Standards Act of 1998.

172 and 141, respectively; in 1996, the number fell to six.[8] Although the figure increased afterwards, reaching 34 cases in 2002,[9] they remain below historical levels.[10]

At the same time, the number of sizable liability cases rose amid the financial frauds that brewed during the late 1990s and came to light in the early 2000s. These included frauds that induced passing the Sarbanes-Oxley Act of 2002, especially Enron, Global Crossing, Qwest and WorldCom. Cases against auditors arising from other frauds included six that produced settlements totaling $1 billion: Baptist Foundation of Arizona, Cendant, Oxford Health, Rite Aid, Sunbeam and Waste Management.[11] Associated frauds and crimes destroyed Arthur Andersen LLP, one of the largest auditing firms.

3. Assessment. The Discussion Outline cites a study stating that the cost of auditor liability in 2004 was about 14.2% of firm revenue ($1.3 billion) up from 7.7% in 1999.[12] Under the principles stated above, a plausible explanation for this, and for the costly frauds referred to in the previous paragraph, is a decline in audit quality in the period when the behavior that led to those costs occurred. This assessment is consistent with evidence that, as auditor liability risk fell during the 1990s, audit firms relaxed their policies on accepting or terminating engagements and other risk management standards.[13]

It is difficult to establish causation between reductions in auditor liability risk and auditor behavior, financial frauds, lawsuit judgments or settlements and firm dissolutions. It is particularly difficult to isolate the contribution of any one step that reduced liability risks during the 1990s because so many occurred in rapid succession. Other factors likely contributed to the era's audit failures, financial frauds and legal penalties. These include issues of audit firm reputation, extensive cross-selling of non-attest services, industry concentration, adopting limited liability audit firm structures, mis-aligned incentives between firms and their partners and lack of oversight. These are discussed in Section II below.

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[8] SEC, Report to the President and the Congress on the First Year of Practice under the Private Securities Litigation Reform Act of 1995 (1997), www.sec.gov/news/studies/lreform.txt.

[9] John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 BOSTON UNIVERSITY LAW REVIEW 301, 342 (2004) (citing PriceWaterhouse Coopers LLP, 2002 Securities Litigation Study 7 (2003)).

[10] Auditors are named as defendants in a small minority of private securities law class actions. Eric H. Talley, *Cataclysmic Liability Risk among Big-Four Auditors: An Empirical Analysis*, 106 COLUMBIA LAW REVIEW 1641, 1680-82 (2006) (in a sample of 2,016 securities law class actions from 1994 to 2005, 8.41% named an auditing firm as a defendant).

[11] Coffee, cited in footnote 9 above, at 342.

[12] Discussion Outline, Item 3.4.1.1.

[13] Jere R. Francis & Jagan Krishnan, *Evidence on Auditor Risk-Management Strategies Before and After the Private Securities Litigation Reform Act of 1995*, 9 ASIA PACIFIC JOURNAL OF ACCOUNTING AND ECONOMICS 135 (2002), www.ssrn.com/abstract=328701.

But it is logical to suppose that systemic reductions in legal liability risk would increase acquiescent behavior. It is not surprising when, following a period of reduced legal risk, more acquiescent behavior occurs, and becomes manifest in subsequent lawsuits exacting payment. For firms, and issuers and investors, the lesson is to maintain a level of liability risk sufficient to deter the acquiescence that leads to costly financial fraud, audit failure and legal penalties.

In assuring sufficient deterrence in any liability system, attention must be paid to the possibility of over-deterrence. This occurs when laws not only discourage undesirable behavior, like acquiescence, negligence and fraud, but stimulate over-abundance of attention, caution, conservatism, skepticism or risk-aversion. In some contexts, overshooting the deterrence mark can reduce innovation or create other undesired side-effects. Any set of rules may be recognized as risking under- or over-deterrence.

For auditing, the service's value rests on the profession's commitment to conservatism in accounting and skepticism in auditing. Those traits are central to auditing's vital role in promoting efficient capital allocation. Consistent with those propositions, when designing an auditor liability system, it is probably more tolerable, when in doubt, to err by providing too much deterrence than too little.

When estimating error, analysts should assess both literal and signaling effects of legal change. Changes to the law governing auditor liability transmit signals to practitioners. Signals can be misinterpreted to induce acquiescence that is neither intended nor warranted. Experience suggests that reductions in auditor liability risk adopted during the 1990s may have sent the wrong signals, even if changes were analytically calculated to be compatible with law's deterrence.[14] It could be desirable to revisit those reductions or otherwise to communicate correcting signals.[15]

B. *Auditor Independence*. The importance of auditor independence reaffirms the point that, when in doubt, it is probably better for investors to pay the costs of over-deterrence than of under-deterrence.[16] Independence is a prime source of auditing's value because it promotes an objective assessment of managerial assertions. It seeks more than to deter auditor acquiescence in managerial preferences by promoting an unbiased basis for professional skepticism on which investors can rely. Reductions in the

[14] For example: (1) the proportionate liability cap on auditor damages retains deterrence against culpable auditor behavior while protecting professionals from exposure to costs generated by culpable conduct of others and (2) the heightened pleading rules filter out non-meritorious lawsuits without excusing auditor liability, retaining deterrence while guarding against vexatious or nuisance litigation.

[15] Some provisions of the Sarbanes-Oxley Act of 2002 may do this for some actors. However, only one, concerning the statute of limitations for private securities lawsuits, reversed 1990s' reductions in auditor liability risk. Sarbanes-Oxley Act of 2002, § 804 (amending 28 U.S.C. § 1658(b)) (suits must be brought within the earlier of two years after discovering a violation or five years after violation occurred).

[16] This can be translated into the Discussion Outline's query whether auditor liability leads to "defensive auditing." Discussion Outline, Item 3.4.1.1. Although the term's meaning is uncertain, defensive auditing sounds more congruent with independence, conservatism and skepticism than its opposite.

stimuli that promote independence therefore jeopardize auditing's reliability. This can increase the cost of capital and result in capital misallocation.

All the various devices that can be imagined to limit auditor liability risk can threaten auditor independence.[17] Explanations appear in recent pronouncements of the following bodies: Federal Financial Institutions Examination Council,[18] SEC and American Institute of Certified Public Accountants. The three separately evaluated one or more among dozens of permutations of devices that can be used to reduce auditor liability risk. Evaluations considered such devices in the context of auditor-issuer contracts.

FFIEC examined a full range of devices and characterized all as "unsafe and unsound."[19] It observed that contractual auditor liability limitations "may weaken the external auditors' objectivity, impartiality, and performance."[20] FFIEC said: "these provisions can remove or greatly weaken an external auditor's objective and unbiased consideration of problems encountered in the external audit engagement and induce the external auditor to depart from the standards of objectivity and impartiality required" in performing a financial statement audit.[21] This can diminish audit usefulness and adversely affect investors and others, as well as the entire financial system.

SEC rules have long prohibited many such devices. The SEC holds that auditor independence is impaired when an issuer agrees to indemnify an auditor for the auditor's negligence because this weakens a major stimulus to the auditor's objective and unbiased consideration.[22] The SEC's Office of the Chief Accountant repeated this stance in a public statement, described as responding to frequently asked questions, adding that the SEC ban encompasses contractual clauses purporting to indemnify an auditor for an issuer's knowing misrepresentations made to the auditor.[23]

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[17] The following is a non-exclusive list, aside from those added during the 1990s and general limitations on lawsuits and liability in the US legal system: (1) type of liability, such as auditor's negligence or misrepresentation or client's negligence or misrepresentation; (2) type of plaintiff, such as issuer, investor or third-party; (3) amount of liability, such as fees received or actual damages (or multiples thereof) or losses arising during limited periods such as those covered by audited financial statements; and (4) procedural rules, such as shortened periods for repose, non-assignment or transfer of claims, ousting courts of jurisdiction in favor of mandatory arbitration, waiving jury trials and assigning costs to losing litigants.

[18] FFIEC is an inter-agency body of the Department of the Treasury's Office of Thrift Supervision and its Office of the Comptroller of the Currency; the Board of Governors of the Federal Reserve; the Federal Deposit Insurance Corporation; and the National Credit Union Administration.

[19] FFIEC, Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters (May 10, 2005).

[20] *Id*.

[21] *Id*.

[22] SEC, Codification of Financial Reporting Policies § 602.02.f.i.

[23] SEC, Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence

AICPA opines that most, but not all, such contractual devices pose an "unacceptable threat to [an auditor's] independence."[24] Devices AICPA deemed compatible with auditor independence were limited to exclusions of punitive damages to the company, indemnifying the auditor from harm arising from management's knowing misrepresentations and mandating private instead of judicial dispute resolution. AICPA's rationale that these devices do not impair auditor independence is that the auditor remains liable to companies, investors and third-parties for injuries caused. AICPA says that other liability-limiting devices impair auditor independence.

C. *Legal Flexibility*. The pronouncements of FFIEC, SEC and AICPA summarized in the preceding sub-section hold that all or most liability limitations appearing in contracts impair auditor independence. If contained in statutes, such limitations would have more pronounced effects on both independence and deterrence. An important difference between contractual and statutory provisions concerns a court's role. Statutes bind judges in ways that contracts do not. Unless unconstitutional, courts are required to apply statutes as written, whether or not deemed concordant with contending public policies.

Judges also enforce contracts as written, but subject to qualifying doctrines that render contracts unenforceable as against public policy. Examples of contracts that are unenforceable as against public policy are those containing unconscionable terms, involving illegal bargains, or purporting to limit a party's liability for certain kinds of torts, especially strict liability, fraud, gross negligence or, sometimes, ordinary negligence. Accordingly, the public policy objections expressed by FFIEC, SEC and AICPA for contractual limitations are stronger in the case of statutory provisions.

A weakness of both contractual and statutory attempts to limit auditor liability risk—or otherwise regulate it—is that informational disadvantages arise from defining rules ex ante.[25] Neither legislatures nor contracting parties can anticipate all the facts relevant to determining, in a particular case, why behavior occurred, its seriousness in context or who is responsible. Ex ante limitations or regulations set under such a veil of ignorance handcuff officials who, ex post, can evaluate all facts to tailor legal consequences to known situations.

Judges generally have discretion to exercise judgment in light of facts rather than being constrained by fiat beforehand. It is possible that, in certain contexts, imperfections of judicial administration and realities of settlement practices reduce the value of judicial discretion. Examples include vexatious or nuisance litigation, used to extract payments

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(Dec. 13, 2004).

[24] AICPA Proposed Interpretation (Sept. 15, 2005). Of course, AICPA stances that conflict with those of the SEC are inapplicable to SEC registrants.

[25] A weakness of contracts in auditing is that contracts are formed between an issuer and auditor, both of which have incentives that differ from those of investors and other users of audited financial statements.

from innocent parties, that judges are somehow incapable of policing. If auditor liability is such a context,[26] it could be prudent to fashion combinations of ex ante legislation or regulation with ex post judicial evaluation. Heightened pleading standards are a specific example.

A general model for this approach appears in various state and federal criminal sentencing guidelines. Legislation or regulation classifies crimes according to severity and, along with a criminal's criminal history, specifies or recommends a range of prison terms or other legal consequences. Such systems can put ex ante constraints on judicial discretion while preserving enough judicial flexibility to respond to facts of particular cases. Analogous legislative, regulatory and judicial coordination could be adapted to the auditor liability system if it is deemed sub-optimally deterrent.

D. *Insurance*. Any deterrence that a liability system contributes can be eliminated if actors can fully insure all related risks. This problem of moral hazard explains why insurance policies invariably contain exclusions or limitations, often through terms like deductibles and retentions. A system in which 100% of losses are covered by third parties would not likely be optimal. On the other hand, having some insurance capacity to cover losses is consistent with the deterrence rationale. Insurance resources may be necessary to pay for injuries caused by behavior undeterred by threat of legal penalties or other incentive or deterrence devices.

1. Resources. It is commonly asserted that today's four largest auditing firms cannot buy commercial insurance directly[27] and some cite this to support reducing liability risk further. Several qualifications should be noted. First, as moral hazard suggests, absence or expense of insurance, on its own, is not a basis for reducing legal risks within a liability system. Second, the assertion is commonly made but not well documented. The assertion often is coupled with the observation that firms use (or "must use") captive affiliates to provide insurance.[28] But firms may opt for such self-insurance simply because they are better than external insurers at assessing and managing risk and evaluating and administering claims. Third, there is evidence that insurers offer, and firms buy, external insurance, certainly to reinsure claims managed and funded through firm captives. Fourth, if such assertions are true, it is not obvious that defects in the liability system are the cause.[29]

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[26] It is not obvious that auditing is such a context, given that auditors are named as defendants in less than 10% of securities fraud class actions. *See* footnote 10 above.

[27] *See* Discussion Outline, Item 3.4.2.2 ("The largest auditing firms are *unable* to purchase commercial insurance directly in the marketplace and *must use* captive insurance funds.") (emphasis added).

[28] *Id.*

[29] *See* Discussion Outline, Item 3.4.2.7 ("Consider the reasons why the largest auditing firms are prevented from being offered commercial insurance.").

2. Required Information. The Discussion Outline's aspiration to "[u]nderstand the insurance and risk management practices of the larger auditing firms in the United States"[30] reflects the importance of obtaining documentation about existing insurance resources. If empirical data are found to support common assertions, consideration might be given to their public dissemination. Disclosure would be useful to promote the legitimacy of proposals to adjust existing deterrence levels. The information should be evaluated in terms of both whether large firms cannot obtain external insurance and, if so, whether this is due to defects in the liability system. In considering this information, moreover, other ways to generate insurance resources, as discussed in Section III below, could be explored.

3. Additional Information. The public might benefit to know what proprietary information auditing firms provide to the Public Company Accounting Oversight Board.[31] The Discussion Outline suggests that firms do not provide audited GAAP financial statements to it.[32] Given PCAOB's oversight role, this is surprising. Firm reluctance to disclose financial resources publicly[33] may be due to a sense that the firms are privately owned, a distinction that is balanced by the public burdens the firms bear. Reluctance may be due to concern that the unscrupulous could use the information to design lawsuits that extract maximal recoveries, including by unmeritorious cases settled at their nuisance value, stopping just short of bankrupting firms. Although this is hard to verify, if such behavior exists, it would be undesirable for firms to publicize financial resources that facilitate it.

An evaluation of proposed changes to the auditor liability system should include assessing probable effects on auditor incentives, auditor independence and judicial flexibility in assessing claims or breaches when facts are known. Statutory limits risk sending the wrong signal, creating the wrong incentives, impairing independence and disabling tailoring remedies to facts of particular cases. The foregoing analysis suggests reasons to believe that the existing liability system's strength should be maintained or possibly increased. The following Section tends to reinforce this tentative conclusion.

II. GOVERNANCE

Aside from law's supply of deterrence, other factors influence the net incentives a system contains. The main factors are the role of reputation, the scope of services a provider sells, relative concentration or competition in a market, the legal form of an organization, the relationship between a firm and its partners, evolving contexts (like

[30] Discussion Outline, Item 3.4.2.3.

[31] Discussion Outline, Item 3.6.1 ("Audit firms provide [PCAOB] with proprietary information").

[32] Discussion Outline, Item 3.6.5 ("Consider whether the auditing firms, themselves, should prepare audited GAAP financial statements for filing with [PCAOB] or the public.").

[33] *Id*.

internationalization) and oversight. In principle, these factors can either reduce or reinforce the need for law to supply deterrence to achieve the optimal level. In the current auditing environment, few of these factors seem to offset the need for law to supply deterrence and some reinforce that need.

A. *Reputation.* For professional service firms, one source of deterrence is the value of a firm's reputation. Rational professionals should be expected to invest in reputation to earn credibility and generate demand for services. How concern for reputation translates into practice varies with professional context. For auditing, reputation's role is vexing because auditors face multiple constituencies: investors, management and board audit committees. Ideally, an auditor would invest in a reputation, projected toward investors, for honesty, coupled with a reputation, projected toward managers, for professional skepticism.

But issuers, not investors, choose auditors and pay their fees. This can mean that auditor incentives are to respond to issuer interests, which can reduce professional skepticism in favor of empathy with management. The Sarbanes-Oxley Act of 2002 reduced this problem by putting control of auditor appointment, supervision and compensation in board audit committees instead of managers.[34] This change probably increases the role of reputation in stimulating professional skepticism and audit quality. Yet issuers still pay their auditor's fees. Accordingly, although the role of reputation may be a net plus, it seems unadvisable to rely heavily on its contribution to deterrence.

B. *Non-Attest Services*. During the 1990s, the percentage of audit firm revenues from auditing services reportedly shrank as revenues from other sources multiplied.[35] Significant cross-selling of non-attest services to audit clients means that auditors can sacrifice material revenue if they exercise skepticism of managerial decisions, sever clients or report them. This can induce acquiescence in auditing. Recognizing this, SEC regulations, codified in Sarbanes-Oxley, prohibit a specific list of services deemed to impair auditor independence.[36] But the list does not ban all services. Current reports indicate that firms are increasingly engaged in non-attest businesses.[37] Relevant to estimating the level of deterrence that law should supply is the mix of firm revenue from attest and non-attest services. The propensity of non-attest revenues to induce

[34] Sarbanes-Oxley Act of 2002, § 301.

[35] William W. Bratton, Jr., *Enron and the Dark Side of Shareholder Value*, 76 TULANE LAW REVIEW 1275, 1350 (2002) (fees from audit clients for non-attest services rose from 13% of revenue in the 1970s to 50% of revenue in the 1990s); Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL LAW REVIEW 775, 786 (2006) (consulting fees rose from 17% of audit fees in 1990 to 67% in 1999).

[36] SEC, Regulation S-X, 17 C.F.R. § 210.2-01(c) (4)(i)-(ix); Sarbanes-Oxley Act of 2002, § 201 (amending 15 U.S.C. § 78j-l).

[37] Jennifer Hughes, *Audit Firms Once Again Making "Consulting Hay"*, FINANCIAL TIMES (Nov. 19, 2007).

acquiescence in auditing can be checked by countervailing devices, including liability risks.[38]

C. *Concentration*. The auditing industry is moderately concentrated.[39] Mergers during the 1990s reduced the number of large firms from eight to five; Arthur Andersen's dissolution reduced it to the four still in existence. These four, reporting some $20 billion in annual revenue apiece, dwarf the next largest firms, which generate closer to $1 billion in annual revenue. Market competition can reduce the need for law to supply deterrence against undesirable behavior. Concentration reduces competition and may have the opposite effect. To the extent that the auditing industry is relatively concentrated, this adds importance to law's deterrent function.

D. *Firm Structures*. During the 1990s, auditing firms changed structures.[40] They shifted from traditional partnerships, in which members were jointly and severally liable, to limited liability entities, in which they are not.[41] This would reduce incentives to maintain internal control or otherwise administer performance standards and client severance policies. It seems unlikely that the observed auditor acquiescence—in audits including Baptist Foundation, Cendant, Enron, Global Crossing, Oxford Health, Qwest, Rite Aid, Sunbeam, Waste Management, WorldCom and others—would occur if individual partners were jointly and severally liable (or other factors discussed in this sub-section contributed stronger deterrence). This factor thus favors a relatively greater supply of legal deterrence.

E. *Mis-Aligned Incentives*. Firms may allow partners to operate under incentives that differ from the firm's. It is irrational for a large firm, whether Arthur Andersen or any still in existence, to stake its survival on a single issuer, whether Enron or any other; it is not necessarily irrational for individual partners to do so. Insufficient deterrence can occur when partners have only one engagement, making their career depend on pleasing its management. Ideally, firms should not allow this to happen. Given that it has happened recently, liability-related deterrence assumes more acute importance than in an environment where firms effectively manage partner incentives.

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[38] *See* Discussion Outline, Item 4.1.3.1.2 ("Consider whether there is an 'appropriate balance' between the auditing services and the non-attest services that auditing firms are providing today.").

[39] *See* Discussion Outline, Item 4.1.1 (citing study showing that four firms audit 78% of US public companies, accounting for 99% of public company revenues). The auditing industry's current Herfindahl-Hirschman Index is 1287, which the Department of Justice considers "moderate concentration."

[40] Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILLA NOVA LAW REVIEW 1167, 1180 (2003).

[41] Larry E. Ribstein, *Limited Liability of Professional Firms After Enron*, 29 IOWA JOURNAL OF CORPORATION LAW 427, 447 (2004); Discussion Outline, Items 3.5.1 ("Most auditing firms in the United States are organized as limited liability entities . . . ").

F. *International Standards*. The emergence of International Financial Reporting Standards in the past two years adds complexity to evaluating liability regimes.[42] Most experts observe that these standards are vaguer than US GAAP (they use more principles than rules). The standards offer more alternative approaches to accounting for identical transactions than US GAAP. This form of accounting standards can frequently lead to different reporting of economically equivalent transactions. That means both that good judgment is required and opportunities for aggressiveness widen.

1. Discretion and Variation. The four largest auditing firms emphasize that using IFRS entails expanded discretion and worry that this increases legal liability risks.[43] This is a genuine concern. It reflects a problem with any global standards. Global standards must be found acceptable to the hundred-plus countries in the world. That, plus their youth, explains why IFRS use vaguer principles than US GAAP. Yet cultures vary across countries and even across companies within a single country. Despite repeated SEC statements that IFRS will increase comparability across enterprises,[44] most people, including those four firms and AICPA, recognize that vague standards and more discretion mean greater variation across enterprises, domestically and internationally.[45]

2. Effect on Deterrence. Auditors may be challenged by this environment. Investors will understandably not appreciate a system in which many similar transactions are accounted for differently, particularly when vocal IFRS proponents, especially the SEC, extol it as promoting comparability. In response, some prescribe reducing auditor liability risk, at least by having the SEC assure auditors that good faith judgments will not be second guessed. Although reasonable given the uncertainty, an equally strong case observes that such a regime, with wider room for aggressiveness, requires more deterrence not less.

G. *Oversight*. Perhaps the most significant reform in the Sarbanes-Oxley Act was creation of PCAOB to provide oversight of auditing firms. Its independent oversight should reduce the need for legal deterrence. Yet it would be asking a lot from such a

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[42] *See* Discussion Outline, Item 3.5.9 ("Consider how the potential acceptance of [IFRS] in the United States and the greater use of fair value and mark-to-model accounting will impact the largest auditing firms' network of affiliates.").

[43] These statements appear in Comment Letters of the four largest firms on the SEC's Concept Release, *On Allowing U.S. Issuers To Prepare Financial Statements In Accordance With International Financial Reporting Standards* (Aug. 7, 2007), http://www.sec.gov/comments/s7-20-07/s72007.shtml.

[44] *See, e.g.*, SEC Press Release, *SEC Takes Action to Improve Consistency of Disclosure to U.S. Investors in Foreign Companies* (Nov. 15, 2007) (announcing ending the requirement that foreign private issuers reconcile IFRS statements to US GAAP); SEC, Concept Release, *On Allowing U.S. Issuers To Prepare Financial Statements In Accordance With International Financial Reporting Standards* (Aug. 7, 2007).

[45] *See* the letters of the four firms referred to in footnote 43 above; *see also* AICPA Comment Letter (Nov. 12, 2007) on SEC's Concept Release, *On Allowing U.S. Issuers To Prepare Financial Statements In Accordance With International Financial Reporting Standards* (Aug. 7, 2007) (judgments required when using IFRS "will sometimes yield different outcomes in similar circumstances").

body to shoulder the entire burden, particularly in light of the foregoing governance matters. Additional reasons for modest expectations include the limited information that PCAOB evidently obtains concerning firm resources noted in the previous Section and recent SEC intervention into PCAOB's standard setting concerning an auditor's responsibilities when auditing internal control over financial reporting.[46] Still, PCAOB's oversight activities should contribute positively to overall system efficacy.

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These governance perspectives tend, on balance, to reinforce Section I's tentative conclusion that it is desirable to maintain, or possibly increase, the existing liability system's strength. Sub-optimal liability design, coupled with these perspectives, could conspire to forge a replay of Arthur Andersen's demise. The following Section elaborates this concern and offers two proposals to avert it.

III. PROPOSALS

The Discussion Outline invites considering alternative insurance structures, to which some of the foregoing discussion leads.[47] The following summarizes two: financial statement insurance (FSI) and auditor liability bonds. Both address the need to preempt the cataclysm that could occur if one of today's four large auditing firms faces massive losses for audit failure. They also offer other advantages.

A. *Preventing Industry Destruction*. Since Arthur Andersen's dissolution, there has been valid concern that one of the four remaining similar firms could face a like fate from kindred criminal or civil culpability. Should that occur, with only three such firms left, a crisis would occur. Many issuers would be unable to engage an independent auditor, either because of conflicts due to non-attest work or lack of expertise within the survivors. Other issues discussed in the previous section, including industry concentration, would be exacerbated. Authorities, firms and issuers would face hurried efforts to break up the surviving three, substitute a government auditing scheme, or reconfigure the role of internal auditors and audit committees into some facsimile of an audit function.

Hazards of this eventuality may now lead authorities and firms to consider those four too big to fail.[48] That is a dangerous attitude because it could prove prophetic.[49] In

[46] *See* PCAOB, Preamble, Auditing Standard No. 5: An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (June 12, 2007) (repealing Auditing Standard No. 2, describing SEC influence on the revision process and how the SEC's definitions and approaches are used in the revised standard instead of those PCAOB originally established).

[47] Discussion Outline, Items 3.4.2.8 ("Consider how altering insurance structures or regimes would impact audit quality.") and 3.4.2.9 ("Consider the costs and benefits of various insurance structures and regimes to investors and the marketplace . . . .").

[48] Discussion Outline, Items 4.1.5.1 ("Consider the sort of risks a larger auditing firm failure poses to the marketplace and investors.") and 4.1.6.2 ("Consider whether regulators are now faced with a "Too Big to Fail" public policy, and if so, consider whether public policy changes are warranted and the nature of those changes.").

the worst case, it induces auditor laxity. Combined with possible under-deterrence as discussed in Sections I and II, this could result in issuers accessing capital markets using materially misstated financial statements. When uncovered, it may be possible to hold responsible only culpable partners within a firm and keep the firm intact.[50] But, depending on scale, this may be politically infeasible. In any event, forces beyond centralized regulatory control could operate, such as client flight, local criminal prosecutions or investor lawsuits. These forces could make the idea that a firm is too big to fail unsustainable. A replay of Arthur Andersen's dissolution is not hard to imagine and, with three instead of four large survivors, the fallout would be more severe.[51] Adverse consequences for the global financial system cannot be ruled out.

Policies should be in place to defeat any notion that those firms are too big to fail; plans should be made to restructure the audit function either to prevent or to anticipate the consequences of such an eventuality. As to policies, this catastrophic scenario fortifies the cautions drawn above against adding more limitations on auditor liability risk and the need to consider increasing deterrence. At present, criminal indictments on a scale matching those that led to Andersen's destruction can best be prevented by sufficient threats of civil and criminal liability along the deterrence lines discussed. As to plans, FSI offers a systemic alternative that would entail substantial changes. Auditor liability bonds offer a market option that, without creating moral hazard or attracting lawsuits, can be implemented promptly to mitigate risk that a large judgment or settlement could extinguish another firm.

B. *Financial Statement Insurance*. Financial statement insurance refers to a system that represents a general alternative to the prevailing system.[52] Under FSI: (1) companies buy insurance policies from insurance companies for a given premium and coverage mix, based on a preliminary insurer investigation, yielding a financial statement reliability index that is much more informative than the current audit report; (2) the insurer engages and pays an auditor to conduct a full audit, making the auditor beholden to insurers, not issuers; and (3) financial misstatements yield policy payouts up to the pre-determined policy coverage level.

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[49] Lawrence A. Cunningham, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry before it Unravels*, 106 COLUMBIA LAW REVIEW 1698 (2006), www.ssrn.com/abstract=928482.

[50] *See United States v. KPMG LLP*, 316 F. Supp. 2d 30 (D.D.C. 2004); *United States v. Stein*, 2006 U.S. Dist. LEXIS 42915 (S.D.N.Y. June 26, 2006).

[51] Nor should one ignore the possibility that more than one large auditing firm could concurrently face the fate of Arthur Andersen LLP, with systemic effects compounding geometrically.

[52] Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA LAW REVIEW 413 (2004), www.ssrn.com/abstract=554863; Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance and GAAP Re-Visited*, 8 STANFORD JOURNAL OF LAW, BUSINESS AND FINANCE 39 (2002).

Several structural improvements stand out compared to the current system: more useful audit-generated information,[53] eliminating a nettling conflict of interest,[54] and providing a determinate resource at stake to promote effective auditing without threatening bankruptcies or other systemic calamities. FSI also overcomes the problems, noted earlier, that arise when legislators try to define liability measures ex ante by legal fiat. Potential advantages include increasing competition among auditors and reducing concerns over whether those firms supply non-attest services to those they audit. More broadly, FSI demonstrates a coherent alternative to the prevailing auditing industry structure that should eliminate any temptation to believe that any firm is too big to fail.

FSI is not perfect. Existing system imperfections may endure or reappear in different forms. But its other virtues should mitigate these. For example, FSI insurers and their auditors have incentives to correct problems discovered in a current audit but to suppress newly-discovered problems covered by prior policies. But auditors face similar conflicts now and, with FSI's potential to increase audit effectiveness generally, this scenario should be less frequent. Second, insurers could pursue a race-to-the-bottom to attract business by giving lenient audits. But that likewise can occur under existing practice and, since FSI adds insurers as direct participants without removing other participants, including auditors, the probability of such gambits succeeding should be low.

C. *Auditor Liability Bonds*. Many agree that the most serious risk requiring immediate attention is catastrophic monetary liability judgments or settlements that destroy a large firm. It is not publicly known what magnitude of penalty would destroy an auditing firm, since firms do not disclose the necessary information. For the largest four firms, estimates range from $500 million to $2 billion.[55] Calls for limitations on auditor liability risk appear intended, in part, to address that. The cautions outlined above induce consideration of other, simpler, less risky alternatives.

Consider auditor liability bonds.[56] Firm affiliates issue such bonds in debt markets to backstop the big lawsuit. Bond maturities are one to three years; principal amounts are a few hundred million dollars. Paying a high interest rate to reflect risk, bonds are repaid at maturity if no catastrophic claims arise but principal is released to cover massive costs if they do.

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[53] Discussion Outline, Items 3.7.2 ("The standard audit report consists of a standardized four paragraphs.") and 3.7.3 ("Consider whether the auditor report should be more descriptive so as to improve communication with the public and investor community.").

[54] Discussion Outline, Item 4.1.2 ("Examine whether there should be fundamental changes made in who pays the audit fee to the auditor.").

[55] *See* Eric H. Talley, *Cataclysmic Liability Risk among Big-Four Auditors: An Empirical Analysis*, 106 COLUMBIA LAW REVIEW 1641 (2006).

[56] Lawrence A. Cunningham, *Securitizing Audit Failure Risk: An Alternative to Caps on Damages*, 49 WILLIAM & MARY LAW REVIEW (Dec. 2007), www.ssrn.com/abstract=1012919.

Share owners are protected against loss from an auditor's proportionate share of culpability without bankrupting firms. Firms benefit from the additional protection that could lengthen their lives. The bonds do not attract lawsuits against auditors and should not increase moral hazard because they fund only catastrophic losses, upwards of $500 million. Insurers keep business they now have writing policies, as bonds cover losses that current coverage does not.

The bonds appeal to investors. Similar bonds have been used since the mid-1990s to fund catastrophic losses from natural disasters, like hurricanes and floods, and liability losses in the oil industry. Nicknamed "cat bonds" to refer to coverage of catastrophic risks, investors enjoy an investment that adds portfolio diversification and a good risk-adjusted return.

Systemic benefits are considerable. Risks of bankrupting a firm fall. Information issues concerning existing insurance resources, and their relationship to the liability system, disappear. Investors increasingly view auditors as partners in promoting reliable accounting not deep pocket guarantors against unreliable reporting. Incentives arise to encourage capital market monitoring of auditors. No government intervention is needed.

A more immediate policy value appears simply from discussing this proposal. Proponents of more limits on auditor liability risk have incentives, when in doubt, to interpret information in ways that overstate stakes. A leading example is the assertion that the prevalence of self-insurance is due to unavailability of commercial insurance. Notably, auditing firms have a comparative advantage in such discussions as they, and their insurers and insurance brokers, have all information on loss histories and risk and hold most of it confidential.

Using this information in policy discussions to promote limitations on liability creates incentives to overstate risks. In contrast, using it in the marketplace to sell auditor liability bonds creates incentives to understate risks. The offsetting incentives would expectedly yield a truer picture. Including this proposal in public policy discussions should therefore be useful. At minimum, policy leaders, lawmakers, journalists, investors and voters should be aware of this alternative, and assess its feasibility, before turning to government intervention.

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